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SUBJECT: INDIA'S ECONOMY: INVESTMENT COULD BE HARDEST HIT,
GOVERNMENT TRYING TO MITIGATE

¶1. (SBU) Summary. As economists the world over grapple with the specter of a significant global slowdown, several groups in India have downgraded their GDP growth projections for the current and next fiscal years, mainly on the expectation that slower world growth will cut export demand. However, while true, merchandise exports comprise less than 20% of GDP. More important, it is the investment boost to the economy through infrastructure that is most under threat and most critical to sustaining India's strong GDP growth rate, as the last five years of growth has been domestic investment and consumption led. The signs are troubling, as India's infrastructure growth had benefited from global financial flows that have virtually disappeared since October. The government itself is prioritizing the infrastructure sector as it considers fiscal and monetary responses to the global slowdown. A proposed \$10 billion infrastructure financing facility funded out of foreign exchange could directly alleviate credit constraints. Whether the government can act in a timely fashion in the midst of state elections and imminent national elections remains to be seen.

¶2. (SBU) Summary continued: Meanwhile, lower inflation brings some respite. The significant drop in inflation boosts the RBI's ability to reduce interest rates, whose tightening since 2007 had contributed to a slowdown in consumer durable and real estate activity. Lower interest rates are therefore likely to boost domestic consumption, which will also be aided by a recent increase in government salaries and the expansion of the rural employment guarantee program. Plummeting commodity prices will also help ease input costs for Indian companies, who saw profits eaten up in the July-September quarter, although they will cause a drag on farm exports in the longer-term. End summary.

Recent Round of Growth Downgrades

¶3. (SBU) The latest worries over a deeper-than-expected global slowdown prompted several revisions to India's projected GDP growth for this fiscal year and next. Citi has revised its GDP growth projection for the current fiscal year to 6.8% from an earlier expected 7.2%, and next fiscal year to 5.5%, while Goldman Sachs expects 6.7% and 5.8% growth during FY09 and FY10. Edelweiss, a local investment bank, has also downgraded its projections in recent weeks from 7.8 to 7.4% for the current fiscal year. Citi expects much slower manufacturing from decreased export demand and lower construction amidst signs of slowing real estate and infrastructure activity.

¶4. (SBU) Data from October definitely suggests a slowdown, with initial estimates of exports in October indicating a 15% year-on-year contraction, excise taxes down by about 8%, and sales of commercial vehicles and 2-wheelers also off. However, it is yet unclear how much of the October slowdown was caused by unavailability of financing versus a drop in demand. Many areas of purchasing power are still strong. The government raised public employee salaries in September, while a rural employment guarantee program was extended across the country last March, and disbursements have far exceeded the last two years'. Indian companies' revenues were quite strong through September, suggesting many areas of domestic demand levels have been sustained.

¶5. (SBU) In addition, some assumptions that economists are using seem overly pessimistic - for example, Edelweiss' service GDP projection assumes that trade, transport, hotels and restaurant growth will mirror that of India's downturn in 1999-2003 - a period that includes world sanctions against India for its 1998 nuclear test and fallout from the 2001 recession and 9/11. Citi is assuming that the agricultural sector will clock only 2% growth this year, but focuses its analysis on grain production, when half of agricultural GDP comes from horticulture, livestock, dairy and fisheries. A few economists expect agricultural growth of 3 to 3.5%. Indeed, there are a few signs the rural economy is doing well. Regional, rural retail franchises reported that September and October were good months for them, as farmers' purchasing power has benefited from recent strong harvests and high government support prices. The \$17 billion farm waiver program may also have helped support spending. However, some parts of the farm economy dependent on international markets, like cotton, rice, spices, shrimp or

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cashews, face greater volatility in the months ahead and a possible slowdown in export orders.

Infrastructure Momentum Threatened

¶6. (SBU) The biggest apparent threat to India's economy from the world slowdown comes more from the disappearance of global financing than of global demand. That is because India's infrastructure boom has relied on cheap foreign financing which has dried up. Infrastructure not only adds critically needed productive physical assets to the country, but also has a multiplier effect in the economy through employment and different ancillary sectors, such as construction, steel, cement, and transport. The disappearance of foreign financing is behind Citi's estimate that investment growth will halve from 13% growth last fiscal year to about 6% in the current fiscal year.

¶7. (SBU) In addition to public infrastructure, such as roads and ports, Indian companies, on the back of rising purchasing power and profit levels, have been investing in significant capacity expansion over the last three to four years. ICICI Managing Director and CEO KF Kamath has estimated that Indian companies spent \$200 billion on expansion in the last two years, which he estimates to come down to around \$140 billion through FY2010. With cheaper foreign financing disappearing, uncertainty about a demand slowdown in India, and potential political volatility from next spring's national elections, companies are starting to postpone expansion plans.

Export Sector Mixed Bag, Modest GDP Importance

¶8. (SBU) Gems and jewelry, carpets, and textile exports have been hit, according to local media, but together they are less than one-fourth of total exports. More important than their impact on GDP is their effect on employment, since these are labor-intensive industries. While media reports of more than 500,000 job losses are probably an exaggeration, as these industries are seeking concessions from the government, the lay-offs do affect economically vulnerable casual laborers with few other options for work.

Available Policy Options

¶9. (SBU) The government has indicated that it considers infrastructure growth a policy priority. Prime Minister Singh identified, prior to the G-20 Summit, the need for international funds to sustain infrastructure projects in developing countries. Planning Commission Deputy Chairman Montek Singh Ahluwalia stated at a conference in New Delhi on November 19 that for fiscal stimulus, there is some room for "quick start" projects, both by accelerating existing road projects and by moving quickly on power mega-projects.

Recent news reports indicate that the government is considering a roughly \$10 billion foreign exchange reserves fund routed through the India Infrastructure Financing Company Ltd.(IIFCL) to finance infrastructure projects. Further, Ministry of Finance Joint Secretary (Multilateral Institutions) Alok Sheel told Econoff on November 20 that the Ministry was engaged in discussions with the World Bank on how to avail of the new infrastructure facility, which could make as much as \$6 billion available to India.

¶10. (SBU) Most analysts, like CRISIL chief economist DK Joshi, feel there is not much general fiscal stimulus the government can enact, as its fiscal deficit is already high and its current budget has already raised government salaries and rural employment funding, among other expansionary spending. However, Ridham Desai of Morgan Stanley told econoffs on November 15 that the government could do "pump priming" through re-starting the privatization of state-owned companies to earn more revenues, as well as cutting taxes. Ajit Renade, Chief Economist, Aditya Birla Management Corporation, also told econoffs that he thought the government could provide some fiscal stimulus through tax cuts, especially for corporations. He also pointed to the implementation slowdown in the National Highway Development Program as a labor-intensive, material-intensive effort that could boost demand if re-energized.

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¶11. (SBU) On the monetary policy side, Citi macroeconomist Rohini Malkani expects recent moves by India's central bank, the Reserve Bank of India (RBI), to ease credit availability for exporters to help. She notes the RBI has extended the period for concessional pre-shipment credit from 6 months to 9 months. In addition, it has increased the limit for banks to extend the export credit refinance limit from 15% of outstanding rupee export credit eligible for re-finance to 50%, which she anticipates will provide an additional \$4 billion of liquidity support to exporters. The government is also considering a \$4 billion fund for small and medium enterprises (SMEs), which have been especially hurt by reduced liquidity and lower banking confidence.

Easing Inflation Helps Too

¶12. (SBU) Inflation's surprise drop to below 9% in recent weeks has increased the odds that India's central bank will lower the benchmark interest rate, currently at 7.5%. Loosening monetary policy should boost consumer durable spending, as lower rates make purchases more affordable, reversing the tightening of the last two years. In addition, steeply lower input prices - from oil to steel to cement - should help improve company's bottom lines. In the July-September quarter, many companies' quarterly results showed strong sales, but erosion of profits from high input costs.

Comment

¶13. (SBU) While external factors are undeniably hitting India, it is not yet clear how much is currently attributable to a loss of global financing and how much to lower global demand. The picture in India is further muddled because, as one contact noted, some companies or sectors are exaggerating the damage in hopes of obtaining additional concessions from the government. India's substantial domestic consumption and investment relies more on available financing than global demand, so improvements on the financing front could blunt a lot of the potential damage to India's economy. The converse is also true. In the meantime, the government's plan to channel a fiscal stimulus through infrastructure is a well-targeted approach to increase demand for

construction, cement, steel, and employment. Though it may take time to implement, it would provide good multiplier effects in the economy and a long-term investment of resources that helps set the groundwork for higher efficiency and productivity once the economy returns to a higher growth trajectory. The poor fiscal practice of funding it off-budget through foreign exchange reserves - even if the reserves can be spared - may have to be overlooked.

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